

---

# The CNB's Macroprudential Policy Strategy



Czech National Bank — Macroprudential Policy Strategy

# Contents

<b>I.</b>	<b>FOUNDATIONS</b>	<b>3</b>
<b>II.</b>	<b>COMPETENCES, POWERS, DECISION-MAKING AND COMMUNICATION</b>	<b>5</b>
<b>III.</b>	<b>THE CNB'S MACROPRUDENTIAL POLICY</b>	<b>7</b>
III.1	Conduct and organisation of macroprudential policy	7
III.2	Macroprudential instruments	8
III.2.1	The banking sector	9
III.2.2	The non-banking sector	11

## I. FOUNDATIONS

The **objective** of **macroprudential policy** is to **safeguard financial stability** using macroprudential instruments. Financial stability is a key prerequisite for the successful long-term development of the economy.

Financial stability is generally defined as a situation where the financial system (financial institutions, markets and market infrastructure) performs its functions with no serious disruptions or undesirable consequences for the present and future development of the economy as a whole, while showing a high degree of resilience to adverse shocks. The key functions of the financial system include financial intermediation between savers and borrowers, the channelling of savings into investment and the provision of payment and settlement services and insurance against risk. Disruptions include in particular significant restrictions on the availability of loans to creditworthy clients and imprudent behaviour by market participants (such as short-sightedness, underestimation of risk and moral hazard).

**Threats to financial stability** arise due to growth in **systemic risk** in the financial system. In other words, serious disruptions or undesirable consequences of adverse shocks affect the entire financial system or a significant part thereof. Systemic risk has two components – a cyclical one and a structural one. **The cyclical component** is due to the procyclical behaviour of financial institutions and their clients over time. Fast-growing risky debt of clients who, together with financial institutions, become highly sensitive to the same macroeconomic factors, are the main source of risk. **The structural component** is due to the interconnectedness of financial institutions and their clients, which is associated with a risk of contagion. The structural component of systemic risk is also linked with excessive concentration of various types of risk and other specific characteristics of the structure of the financial system and the economy.

**Systemic risk** usually arises gradually and unobserved, and the situation in the financial system may not show obvious signs of an adverse state or adverse developments. In such periods, financial institutions and their clients tend to succumb to over-optimism, underestimate risks, take on too much debt and create unstable financial links and, moreover, appear highly resilient. The subsequent materialisation of the accumulated risks in the form of a **financial crisis** has a strongly adverse long-term impact on economic growth and can have huge social consequences. Historical examples include the 1930s' Great Depression and the 2007–2009 Global Financial Crisis.

The work of the **European Systemic Risk Board** (ESRB),<sup>1</sup> which the CNB is a member of, helps reduce systemic risk in financial systems across EU countries. ESRB members identify major risks in the EU, and the ESRB issues **warnings and recommendations** in order to mitigate them. Warnings and recommendations are also addressed to individual states, as the national macroprudential authority is responsible for conducting macroprudential policy in each EU country. Most activities in the financial system are performed by financial institutions having their legal domicile in the EU Member State concerned, and those activities are also often local in nature.

**The CNB, which is a macroprudential authority, is responsible for financial stability policy-making in the Czech Republic.** It bases its work primarily on Czech and EU legislation. It also takes into account the outputs of the European System of Financial Supervision (ESFS),<sup>2</sup> the European System of Central Banks (ESCB) and the Basel Committee on Banking Supervision (BCBS), outputs to which it also contributes as a member of these institutions. It aims to ensure sufficient international exchange of information and to share best supervisory practices. At the same time, it seeks to ensure that the fundamental characteristics and specificities of the Czech financial system and real economy are taken sufficiently into account so that the regulatory environment and the methodological and analytical approaches used help maintain financial stability in both the Czech Republic and the EU.

Owing to the cross-border interconnectedness of the Czech financial system with other, mainly EU, financial systems (foreign ownership of financial institutions operating in the Czech Republic and exposures to foreign entities), the CNB as a macroprudential authority takes into account the economic policies of other countries, for example, monetary policy, policy in the area of supervision and licensing of financial market entities, and fiscal policy, as some of those countries' actions may significantly affect the risks to financial stability in the Czech Republic.

**Financial stability objectives are multi-dimensional in nature**, and macroprudential instruments transmit to changes in the behaviour of financial institutions and their clients in quite a complex manner. In some cases, objectives can be achieved effectively with the support of other types of policies.

<sup>1</sup> [Regulation No 1092/2010 of the European Parliament and of the Council](#) on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, Chapter I, Article 3(1). The ESRB, together with the sectoral authorities (the EBA, ESMA and EIOPA), is part of the European System of Financial Supervision (ESFS).

<sup>2</sup> Pursuant to Articles 114 and 127(6) of the [Treaty on the Functioning of the European Union](#), the European System of Financial Supervision (ESFS) comprises the ESRB, the three European Supervisory Authorities (the EBA, ESMA and EIOPA) and the supervisory authorities of individual Member States.

The CNB takes the configuration of [microprudential policy](#) into account when pursuing its macroprudential policy, as the instruments of the two policies are focused on the same institutions in the financial system and use similar information bases. A lot of the information obtained in the course of microprudential supervision (for example during on-site examinations and at meetings of colleges of supervisors for cross-border banking groups) and the Pillar 2 requirements are taken into account in macroprudential policy-making. The CNB aims to ensure that the two policies complement each other and to avoid overlaps of the instruments used with respect to the risks being mitigated.

The CNB also takes its own [monetary policy](#) into account when pursuing macroprudential policy. Although the two policies have different objectives – price and financial stability respectively – and use different instruments, they operate through common transmission channels and the scope for interaction between them is quite wide. In reality, price stability is hard to achieve when the financial system is unstable and, conversely, financial stability is hard to achieve when prices are unstable. This close relationship predetermines the need to monitor and assess the impact of the measures of these two policies on the attainment of their objectives – especially the medium-term ones – and, if necessary, to coordinate them. Through the joint action of monetary policy and macroprudential policy, the CNB contributes to maintaining confidence in the value of the Czech koruna and safeguarding the stability of the macroeconomic environment.

The CNB has also been assigned the role of [resolution authority](#). This has increased the importance of coordinating work in the areas of financial stability and resolution. Resolution principles and instruments have significant overlaps with financial system stability. Instruments of the two policies reduce, for example, concentration risks and the risks arising from the interconnectedness of financial institutions. Resolution is a process that ensures that the failure of an institution proceeds properly and quickly, thereby effectively preventing adverse shocks from spreading inside the financial system.

Finally, responsibility for financial stability is linked to work in the area of the [regulatory framework](#). The CNB submits suggestions for preparation and comments on draft interpretive opinions and legal rules relating to prudential policy. Of particular importance in this context is its legislative **cooperation with the Czech Ministry of Finance**, which is responsible for preparing the regulatory framework for the functioning of the Czech financial market. The CNB also develops cooperation with other units of the state to the extent appropriate to support the performance of its financial stability duties.

## II. COMPETENCES, POWERS, DECISION-MAKING AND COMMUNICATION

### Mandate

The CNB's mandate for conducting macroprudential policy is laid down in the Act on the CNB<sup>3</sup>:

#### Article 2

(1) "...the Czech National Bank shall work to ensure financial stability..."

(2) "... e) set macroprudential policy by identifying, monitoring and assessing risks jeopardising the stability of the financial system and, in order to prevent or mitigate these risks, contribute by means of its powers to the resilience of the financial system, the reduction of growth in systemic risks and the maintenance of financial stability; where necessary, it shall cooperate with the relevant state authorities in setting macroprudential policy;..."

The CNB's [Financial Stability and Resolution Department](#) is responsible for financial stability and macroprudential policy.

### Principles of the application of macroprudential policy

The CNB's macroprudential policy seeks to have a **preventive** effect, i.e. to prevent conditions for future financial instability from arising, and to have a **corrective** effect, i.e. to mitigate the impacts of adverse macrofinancial shocks. The CNB conducts its macroprudential policy in such a way as to anticipate systemic risks and to make the financial system more resilient to manifestations of these risks in a timely manner. It does so on the basis of clearly defined procedures<sup>4</sup> and using [specified instruments](#), thus **avoiding** the risk of **inaction bias**. Such bias may arise at times of high uncertainty about the severity of accumulating systemic risk and its manifestations, when this risk is not easy to quantify either through the usual financial indicators or using more complex models. With regard to the long-term sustainability of financial stability, the CNB must act even if the initial social costs of its actions may seem high. The CNB regularly **assesses the efficiency and effectiveness of the applicable macroprudential instruments** in relation to the levels of each type of systemic risk and the other policy instruments already applied. If systemic risks decrease or are addressed sufficiently by other instruments, it will adjust its macroprudential instruments accordingly.

As a macroprudential authority, the CNB affects [financial institutions operating in the Czech Republic](#) and, through them, non-financial private entities (such as loan applicants, investors, borrowers and savers). It always carefully considers the **effect of the powers it applies on the activities and regulatory burden of the entities concerned**. The CNB is aware that macroprudential policy creates some restrictions on regulated entities and their clients. These restrictions may be unpopular and become a source of criticism, including by means of media pressure. This is particularly the case where systemic risk is mitigated by vigorously applying instruments that affect the interests of a large number of market participants. The CNB therefore also focuses on explaining its actions, as some measures yield **positive effects in the long run** (the maintenance of long-term financial stability), effects which may not be visible at first glance. The CNB also sees to it that its macroprudential policy-making expenditure is efficient and effective by, among other things, allocating the largest proportion of its resources to the parts of the financial system that provide critical functions for the real economy.

### Decision-making and communication

The CNB is independent in deciding on the application of its powers to safeguard financial stability and formulate macroprudential policy.<sup>5</sup> As a rule, the **CNB Bank Board** decides on the application of macroprudential measures. It usually does so at its quarterly **meetings on financial stability**, based on detailed analyses regarding systemic risk in the Czech financial system. Nevertheless, where necessary, the Bank Board may take relevant decisions on such measures at its other regular or extraordinary meetings.

The CNB provides information about the Bank Board's decisions at a press conference given by a Bank Board member, in a press release and in the [CNB Board decisions](#) section of its website. The CNB maintains a summary of all applicable legally binding and legally non-binding macroprudential policy acts in the [Financial stability](#) section of its website.

<sup>3</sup> [Act No 6/1992 Coll., on the Czech National Bank](#) (hereinafter the "Act on the CNB").

<sup>4</sup> The CNB publishes methodological documents describing its approach to configuring macroprudential instruments and conducting stress tests in the [Financial stability](#) section of its website.

<sup>5</sup> [Article 9 of the Act on the CNB](#): (1) When carrying out the primary objective of the Czech National Bank and when exercising the powers and carrying out the tasks and duties conferred upon them by the Treaty on European Union, the Treaty on the Functioning of the European Union and the Statute and when performing other activities, neither the Czech National Bank, nor the Bank Board, nor any member of the Bank Board shall seek or take instructions from the President of the Republic, from Parliament, from the Government, from administrative authorities of the Czech Republic, from the bodies, institutions or other entities of the European Union, from governments of Member States of the European Union or from any other body. (2) The Czech National Bank and the Government shall inform each other on matters concerning the principles and measures of monetary, macroprudential and economic policy.

In order to ensure public awareness, predictability of its actions and transparency in maintaining financial stability and formulating its macroprudential policy, the CNB issues a [Financial Stability Report](#) twice a year. It submits the Financial Stability Report to the Chamber of Deputies once a year for information. It provides information about its analytical methods and approaches to the application of macroprudential instruments by means of methodological documents, [thematic articles on financial stability](#) and [research publications](#), which are also published on the CNB website. Where necessary, it also communicates flexibly with the public (in articles, interviews and [blog posts](#)). In the process of macroprudential policy formulation, the CNB also communicates with the official interest groups of the various parts of the financial sector (especially sectoral associations), the academic and professional community, and the public. The aim is to apply a considered and balanced approach based on a constructive dialogue with potentially affected market participants.



### III. THE CNB'S MACROPRUDENTIAL POLICY

The CNB's macroprudential policy is **in principle forward-looking**. It applies macroprudential measures which are able to reduce the vulnerability of the Czech financial system in good time by limiting systemic risk, and to strengthen the resilience of the system in case this risk materialises. On the one hand, the CNB aims to create timely barriers in the financial system against **collective risk-taking**, which, for various reasons, financial market participants may not be able to fully identify, evaluate and cover with buffers at a given point in time. On the other hand, **assessing the resilience** of the financial system to adverse shocks is also a significant element in the application of macroprudential policy. It is particularly important for systemically important institutions. The CNB takes into account the level of resilience to adverse economic developments both in its decisions to apply macroprudential instruments and in the calibration of those instruments.

Macroprudential policy must be based on the assumption that the largest systemic risk is born in the best of times (**the financial stability paradox**). Severe crises tend to arise after prolonged good times, which start to be perceived as more or less permanent. In such times, economic agents show a reduced ability to perceive and value risks, and a large number of them may take financial and investment decisions which are capable of posing a threat to their own financial stability and the stability of the entire financial sector. Macroprudential policy can narrow the space for the mass spread of such (often irrational) decisions and reduce the potential extent of the risks through the application of **countercyclical instruments**. Those instruments lead to the formation of buffers, which in turn make it possible for economic agents to cope better with any consequences of their bad decisions.

The CNB's macroprudential policy is **not aimed at delivering full stability of the financial system at every moment in time** and at applying a set of instruments that will completely prevent any market swings. Although such efforts would significantly mitigate the private sector's risk, they would also hamper market participants' business and thus have a negative effect on long-term economic growth in the Czech Republic. The aim is to minimise the probability that the materialisation of the risks undertaken will cause extensive disruptions in the financial system with strongly adverse impacts on the real economy and a need to use large amounts of public funds. So, rather than fighting market mechanisms, macroprudential policy only involves combating certain market inefficiencies and failures (short-sightedness, herd behaviour, underestimation of risk, moral hazard, structural failures), which can be considered negative externalities.

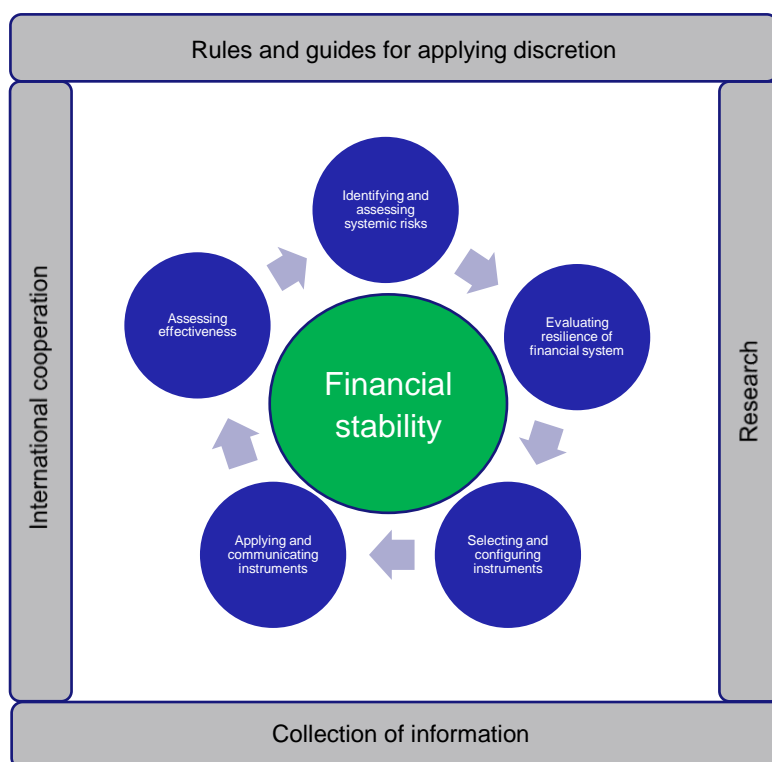
Owing to the cross-border interconnectedness of the Czech financial system with financial systems in other countries, the CNB also takes into account any coordination of its macroprudential policy with prudential policies in other relevant countries ("home-host coordination", such as the division of competencies between the foreign regulator and the Czech regulator, the regulation of exposures, and the division of capital within international financial groups). Another area of coordination is [mutual recognition of macroprudential measures between countries](#). Some measures taken by macroprudential authorities in other countries may be linked with risks to financial stability in the Czech Republic and vice versa. However, before recognising foreign macroprudential measures, the CNB always assesses whether the related risks are sufficiently material to financial stability in the Czech Republic.

#### III.1 CONDUCT AND ORGANISATION OF MACROPRUDENTIAL POLICY

The conduct of macroprudential policy is based on an **analytical framework** involving regular forward-looking assessment of the level and evolution of systemic risk and the resilience of the financial system to potential adverse macrofinancial shocks. From the procedural perspective, the conduct of macroprudential policy can be described in several interrelated phases (see Figure 1).

In the **identification and evaluation phase**, the CNB focuses on the **intensity** of potential systemic risk. This phase mainly involves creating and continuously assessing systemic risk accumulation indicators based on modelling of the financial system and intrinsic characteristics important for assessing financial stability. This phase also involves conducting ad hoc or regular surveys (such as the [Bank Lending Survey](#)) to obtain data which are not available from the usual reporting. The assessment of the risks identified is also based on economic theory, empirical observations and expert judgement. It must be focused on the actual degree of potential risk, not just the currently perceived level of risk.

In the phase of **evaluating the resilience of the financial system**, the CNB focuses on [stress testing](#) the financial and non-financial sectors and their interconnectedness. The CNB tests the resilience of sectors to potential highly adverse or crisis developments and to the most likely macroeconomic developments. It takes into account the level of resilience to adverse economic developments both in its decisions to apply relevant macroprudential instruments and in its decisions on their limits and levels.

**Figure 1:** Elements of the conduct of macroprudential policy

In the phase of **selecting and configuring its instruments**, the CNB assesses their efficiency and effectiveness relative to the risk identified, i.e. their optimal levels (calibration), their impacts on the costs and activities of market participants, the risks of regulatory arbitrage, the effects of the instruments of other policies, and circumvention of the set duties. It strives to obtain a thorough knowledge of their transmission channels, i.e. the mechanisms through which each instrument affects the behaviour of market participants in the context of the fulfilment of financial stability sub-objectives.

In the **instrument application and communication** phase, the CNB aims to curb or mitigate systemic risk and maintain the resilience of the financial system. It does so by setting the level, scope, legal form and manner of communication of the instruments it uses so that they contribute as effectively as possible to limiting the materialisation of systemic risk. In this context, the CNB also defines the institutional and organisational framework for communicating the instruments it applies and regularly informs experts and the general public about developments in the area. In this context, it creates a methodological framework through which it provides information about the rules for the application of instruments.

In the **assessment of effectiveness** phase, the CNB uses analytical methods to assess the effects and impacts of the macroprudential instruments it has applied. Further to the assessment results, the CNB takes the action it deems necessary to ensure that these instruments are effective.

The CNB initiates [economic and financial research](#) and actively applies the results in all phases of macroprudential policy formulation. Research results serve as a tool for checking the quality of the methods and models used to analyse financial stability and assess the effectiveness of macroprudential instruments. The use of the information, experience, findings and methodological and regulatory approaches of foreign central banks and macroprudential authorities also plays an important role. The CNB also collaborates with academic institutions, research organisations and international institutions in the research area, thereby enhancing its understanding of global trends and their impacts on the domestic economy. This collaboration enables the CNB to respond more effectively to emerging new risks and challenges.

### III.2 MACROPRUDENTIAL INSTRUMENTS

The CNB applies its [macroprudential instruments](#) both individually and simultaneously and has the following types available:

1. **Legally binding instruments** applied to entities regulated and supervised by the CNB, non-compliance with which is subject to penalties. Instruments defined in Czech and EU law have the strongest legal position. They include:



- a) instruments relating to capital, capital buffers, risk weights on exposures, credit ratios, liquidity and concentration of assets, mostly those of the banking sector;<sup>6</sup>
  - b) instruments which the CNB may use for a period of six months (in the form of a provision of a general nature) to mitigate the consequences of or to curb risks which are not anticipated and relate to the banking sector;<sup>7</sup>
  - c) instruments limiting the leverage ratio for investment funds.
2. **Instruments based on recommendations**, which are not laid down directly in the legislation. The CNB uses these instruments to recommend specific conduct to regulated or other entities in order to reduce risks to financial stability. Recommendations may be public or confidential. Although they are legally unenforceable, regulated entities are obliged to give the CNB reasons for not complying with them. If the CNB assesses the reasons as unconvincing, it may consider the entity's behaviour imprudent and apply all its remedial powers and options.
  3. **Communication instruments** can be directed universally and thus affect the risk perceptions of market participants. A change in risk perceptions can change behaviour and hence affect the level of risks to financial stability. In addition to analytical and research texts, these instruments include press releases, interviews in the media, presentations at professional events and journal articles by CNB representatives.

Macroprudential instruments can have quantitative or price effects. **Quantitative** instruments consist in introducing certain limits which can limit the scope of activities carried on by financial institutions and the size of their assets and liabilities. Price instruments affect how the risks undertaken are reflected in **prices of financial services**. In reality, most instruments affect both prices and quantities.

The definition of macroprudential policy instruments and their appropriate application in the banking and non-banking parts of the financial system is being continuously developed by ESRB working groups. As well as enhancing knowledge of the macroprudential instruments already in place, the ESRB pays great attention to developing macroprudential instruments in areas where macroprudential authorities have so far had no appropriate tools to fulfil their mandate. The CNB is actively involved in the preparation of proposals for new macroprudential instruments and contributes to the creation of best international practices.

### III.2.1 The banking sector

The CNB has a set of macroprudential instruments that it applies mostly to **the banking sector**, which has the dominant role in the domestic financial system. The CNB deploys these instruments to ensure that the sector has strong capitalisation, a stable liquidity position, an appropriate level of risks undertaken, especially credit risks, and resilience to the adverse phase of the financial and economic cycle.

In accordance with an ESRB recommendation,<sup>8</sup> the CNB's selection of suitable macroprudential instruments for the banking sector is based on [intermediate objectives \(see Table 1\)](#) which reflect the existence of multiple sources of systemic risk and their transmission mechanisms. The key objectives include: (i) to mitigate excessive credit growth and leverage and strengthen the resilience of the banking sector; (ii) to limit structural systemic risks and strengthen the resilience of the banking sector; (iii) to mitigate excessive maturity mismatch and illiquidity; (iv) to limit risks associated with exposure concentration; (v) to limit risks associated with misaligned incentives; and (vi) to strengthen the resilience of financial infrastructures.

**Capital buffers** are the key instrument in the case of the banking sector. In the Czech financial system, there are three types of buffers: buffers to cover the risks of systemically important institutions, buffers to cover cyclical risks and buffers to cover structural risks. These capital buffers have a cumulative effect. Each has its specificities. The CNB sets them to be complementary.

The [capital buffer for other systemically important institutions](#) is used by the CNB to curb systemic risk arising from the potential destabilisation of important banks or consolidated groups in the Czech Republic.<sup>9</sup> The destabilisation of any of the systemically important banks could undermine confidence in the banking sector's ability to provide its services effectively, which in turn could have serious repercussions for the financial system and the entire economy. The CNB calibrates macroprudential instruments using its own methodology based on [EBA guidelines](#). The buffer for systemically

<sup>6</sup> [CRD/CRR](#) and the [Act on the CNB](#).

<sup>7</sup> Article 26bb of [Act No. 21/1192 Coll., on Banks](#), which applies to banks, foreign bank branches, groups of banks defined by type and groups of foreign bank branches defined by type.

<sup>8</sup> [ESRB recommendation on intermediate objectives and instruments of macro-prudential policy](#) (ESRB/2013/1).

<sup>9</sup> [Article 12v of Act No. 21/1992 Coll., on Banks](#)

important institutions should not usually be drawn on just because the economy has entered the downward phase of the financial cycle.

The CNB's toolkit also includes the [countercyclical capital buffer](#).<sup>10</sup> The CNB may apply it to increase the banking sector's resilience to risks associated with the financial cycle, especially in the form of large fluctuations in lending and the level of credit risk materialisation, which amplify cyclical swings in economic activity. At the same time, it to some extent reduces the room for mass risk-taking due to over-optimism in sustained economic good times. If the CNB assesses that the cyclical component of systemic risk is growing, it increases the countercyclical capital buffer rate, thereby strengthening the future resilience of the domestic banking sector. Conversely, at times of decreasing cyclical risks or increasing financial stress and rising credit losses and capital requirements, the CNB is ready to lower or release the buffer so that it can be used to cover losses or to lend to the real economy. This instrument should prevent the transmission of an additional shock from the banking sector to the real economy while maintaining the supply of credit from banks to creditworthy clients.

**Table 1:** Intermediate objectives, risk specification and macroprudential policy instruments for the banking sector

Intermediate objectives	Risk specification	Key instruments
To mitigate excessive credit growth and leverage and strengthen resilience of banking sector	Stronger credit growth accompanied by easing of credit standards Increasing leverage, increasing off-balance sheet risk Low level of risk weights in major credit portfolios Risk growth in specific sector Risk growth in housing credit market Risk of excessive household indebtedness and debt service of households	Countercyclical capital buffer Macroprudential leverage ratio Macroprudential instruments setting minimum risk weights or LGD parameter (Articles 124, 164 and 458 of CRR). Sectoral systemic risk buffer LTV limit DTI and DSTI limits
To limit structural systemic risks and strengthen resilience of banking sector	Structure of economy and financial system, including cross-sectional risks (climate risk, cyber risk, etc.)	General systemic risk buffer Sectoral systemic risk buffer Macroprudential instrument to reduce systemic risk at national level (Article 458 of CRR)
To mitigate excessive maturity mismatch and illiquidity	Long-term liquidity risks Short-term liquidity risks	Macroprudential NSFR Macroprudential LCR
To limit risks associated with exposure concentration	Concentration of real estate exposures Concentration of sovereign exposures	Sectoral systemic risk buffer Public finance stress test (Pillar 2)
To limit risks associated with misaligned incentives	Risk of propagation of problems in systemically important institutions to financial market and real economy	Capital buffers based on systemic importance (G-SII and O-SII buffers)
To strengthen resilience of financial infrastructures	Counterparty default risk, interconnectedness of financial infrastructures	Margin and haircut requirements on counterparty clearing Increased disclosure Sectoral systemic risk buffer

Note: The classification of intermediate objectives and instruments is based on Recommendation of the ESRB of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy (ESRB/2013/1).

The CNB uses the [systemic risk buffer](#) to increase the sector's resilience and mitigate structural systemic risks (cross-sectional risks of a long-term non-cyclical nature), which may concern specific groups of banks and segments of credit exposures.<sup>11</sup> These primarily include risks relating to financial links within the financial sector, common exposures across banks, the structure of the banking sector, financial links to the real economy and its structure, and the transition to a sustainable economy (part of climate risk). The CNB may set a general buffer or a sectoral buffer. The buffer is only used

<sup>10</sup> [Article 12o of Act No. 21/1992 Coll., on Banks](#)

<sup>11</sup> [Article 12r of Act No. 21/1992 Coll., on Banks](#)

to cover cross-sectional risks that are not covered by other instruments. The CNB regularly evaluates all relevant structural risks. If it identifies them as systemically important (either on their own or in combination with other risks), it decides to set an appropriate buffer rate. The CNB releases the systemic risk buffer if the risks have disappeared or materialised.

The CNB's other macroprudential instruments include upper limits on [credit ratios](#) in the area of **consumer loans secured by residential property** (borrower-based measures).<sup>12</sup> These ratios include debt-to-income (DTI), debt service-to-income (DSTI) and loan-to-value (LTV). The CNB may set or recommend borrower-based measures if it identifies systemic risks relating to such loans. The primary purpose is to limit banks' potential credit losses and to mitigate risks associated with household overindebtedness that have the potential to acquire systemic importance. LTV limits make it possible to limit any credit losses given default and a decline in the value of collateral. The aim of the DTI and DSTI limits is to reduce the probability of default in an adverse economic situation. The CNB bases the limits on its own methodologies.

The CNB may also address macroprudential or systemic risk identified in the Czech Republic by applying stricter measures at the national level using **Article 458 of the CRR**.<sup>13</sup> Measures applied under this article generally serve to cover specific risks that cannot be covered equally effectively by other prudential instruments. This instrument can therefore be used, for example, to cover risks to financial stability associated with the level of capital (e.g. the macroprudential leverage ratio), minimum risk weights and parameters for calculating them, large exposures and liquidity. The application of Article 458 and the coverage of some of these risks by microprudential instruments are not mutually exclusive.

The elements of macroprudential policy instruments for the banking sector are described in detail in [The ESRB Handbook on Operationalising Macro-prudential Policy in the Banking Sector](#). Nevertheless, the ESRB handbook is not binding on the CNB and may not even represent the best practice in the specific national conditions. The CNB therefore creates its own procedures when implementing its instruments.

Besides expressly macroprudential instruments, fulfilment of financial stability objectives can also be aided by microprudential **regulatory and supervisory instruments**, such as [liquidity requirements](#), maturity or currency mismatch limits, caps on the size of exposures to individual institutions, sectors or regions, and various rules, prohibitions and requirements in areas such as internal risk management and asset valuation procedures, internal structures of financial institutions, governance and ownership relations with institutions in other countries.

### III.2.2 The non-banking sector

Macroprudential policy also covers **non-banking part of the financial system**, albeit to a lesser extent. The CNB assesses the activities and position of non-bank financial institutions on an ongoing basis and, where necessary, may respond to adverse changes in systemic risk and insufficient resilience. At present, it may thus apply existing macroprudential instruments in some segments or initiate changes to the regulatory framework in order to strengthen their legal force. However, the CNB maintains that macroprudential policy instruments should be applied to the non-banking part of the financial sector only insofar as non-bank institutions can adversely affect financial stability, both directly via their critical functions for the real economy and indirectly through the links between non-bank institutions and the banking sector.

**Macroprudential policy outside the banking sector** – specifically the development and application of new macroprudential instruments – is one of the ESRB's long-term priorities. The CNB is actively involved in international activities and supports the work of the ESRB, EIOPA and ESMA.<sup>14</sup> It also participates in other international initiatives targeted at developing macroprudential policy, especially **in the sectors of insurance companies, pension management companies and investment funds, which form the largest parts of the non-banking segment of the Czech financial system**.

In the case of the insurance sector, the options for a macroprudential response to the build-up of systemic risks remain rather limited so far. However, Solvency II is currently undergoing an update that includes the possible introduction of macroprudential instruments for insurance companies. Given the existence of systemic risks, the CNB could thus use macroprudential instruments consisting mainly of restrictions on profit distribution and dividend payments to owners and the temporary suspension of termination settlements to life insurance clients in the event of liquidity problems. The functioning of the pension management companies and pension funds sector is currently governed by national legislation.

<sup>12</sup> [Articles 45a–c of the Act on the CNB](#)

<sup>13</sup> [Article 458 of CRR](#)

<sup>14</sup> [EIOPA](#) and [ESMA](#) are, respectively, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority.

This provides the CNB with extensive powers. These include assessing the financial condition, risks, capitalisation and resilience of supervised entities on an ongoing basis.

The rapidly growing emphasis on risk assessment and the development of macroprudential instruments in the investment fund segment is a response to significant growth of investment funds in terms of total assets and systemic importance. Given the existence of a risk to the functioning of the financial system, the CNB may set a limit on the leverage ratio of investment funds, thereby reducing the segment's sensitivity to volatility in market prices and their contribution to the risk of fire sales. Efforts are being made at the European level to develop a general risk assessment framework and possibly extend the macroprudential toolkit for the investment fund sector. In addition to risks associated with excessive leverage, these efforts will focus on mitigating risks stemming from significant liquidity mismatches between assets and liabilities.